

F. BID SUPPLEMENT AND REBATE PROGRAMS OF IRC 501(c)(5) LABOR ORGANIZATIONS

**by
Carter Hull and Gerald Sack**

1. Introduction

The purpose of this chapter is to relate how the Service treats bid supplement and rebate programs of construction industry labor unions that are recognized as exempt under IRC 501(c)(5). Local labor unions have requested many private letter rulings on whether these programs would adversely affect their exempt status. Our experience has been that these programs are clearly within the unions' exempt purposes.

Because the private letter rulings on these programs concern exempt status, they are not issued under IRC 6110 and are not, therefore, readily available to researchers and the public. By providing an explanation and discussion of the Service's handling of these programs in this CPE text, practitioners and Service personnel will be better able to judge whether future private letter rulings are necessary.

2. Background

There is a fairly common misconception that labor organizations exempt under IRC 501(c)(5) are able to do just about anything even faintly related to "labor" under their exemption without fear of revocation or denial. Even some of the labor organizations themselves seem to harbor this misconception. It is true, however, that IRC 501(c)(5) appears to be one of the least restrictive of all the exemption provisions. The Code merely states that "labor, agricultural, and horticultural organizations" are exempt from federal income tax. There are no explicit statutory definitions, limitations, or prohibitions. Indeed, the only restrictions barring exemption under IRC 501(c)(5) seem to be those implicit in the statute and a prohibition on inurement, as set out in the regulations.

The Service defines "labor organization" under IRC 501(c)(5) in its commonly accepted sense. The essential qualifying character of a labor organization is that it has as its principal purpose the representation of employees in such matters as wages, hours of labor, working conditions and economic benefits, and the general fostering of matters affecting the working conditions of

its members.

Reg. 1.501(c)(5)-1(a) provides that the organizations contemplated by IRC 501(c)(5) as entitled to exemption from income taxation are those which: (1) have no net earnings inuring to the benefit of any member, and (2) have as their objects the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations. This brief regulation provides no separate rules, conditions, or definitions for labor organizations as opposed to agricultural or horticultural organizations. As a practical matter, however, certain activities, such as the provision of insurance for members, are exempt activities for exempt labor organizations, but not for exempt agricultural organizations.

The construction industry in the United States has undergone a radical transformation in the past decade. The once dominant unionized section of the industry has experienced a rapid and steady decline in its share of the construction market. The union contractor has been virtually eliminated in many areas of the country, and has withdrawn or been restricted from competing in major segments of the market in other areas. If this trend continues, the union sector could, for most purposes, simply cease to exist in the near future.

The unions believe that the conditions that led to the growth of non-union construction are not irreversible. It has been stated that the major barriers to the recovery of union construction fall into three general categories. First, escalating costs due to low productivity and work stoppages have made union contractors noncompetitive. Second, the non-union sector aggressively and systematically promotes and markets its product. Third, there is increasing user resistance to union contractors based on a combination of the first two factors. The union sector, however, believes that it can develop a comprehensive program to remedy these problems, and restore its position as a productive and competitive force in the construction market. It sees a clear opportunity and a definite need for the restoration of the union sector.

The transformation of the construction industry from predominantly union to non-union may not be without its negative consequences for the industry and the construction user.

The unions claim that the performance of the non-union sector has not met its promise of low cost along with high quality construction. The union sector also claims that the non-union sector has been plagued with poor quality performance,

cost overruns, and an inadequately trained and unstable work force. The union sector believes that it remains superior in areas critical to the future of the construction industry, such as long term investment in apprenticeship and training programs, the development of a stable local labor supply through the use of local hiring halls, and the retention of experienced workers through the provision of medical, pension, and other benefits.

3. Bid Supplements and Rebates

One of the programs espoused by the union sector in the past few years to counter the trend to non-union construction is utilized at the local level and is known as the bid supplement or rebate program. The program starts with a local construction industry union that is recognized as exempt under IRC 501(c)(5) and thus, by regulatory requirement, has as its objects to better conditions of its workers, to improve the grade of their products, and to develop a high grade of efficiency in their respective occupations.

The members of the local union approve a resolution to create an "advancement" fund, or "target" fund. The purpose of the fund solely or primarily is to promote the organized industry within the jurisdiction of the local by enhancing work opportunities for employees and signatory contractors. This purpose is effectuated by means of bid supplements or rebates on certain projects. Basically, the fund pays directly to the contractor an amount that works to offset the cost of the usually higher-priced union workers. Secondarily, and occasionally, the fund is also used to take steps to organize non-union employees through advertising, educational programs, productivity studies, and related activities. The fund is funded by the members' payment of periodic dues based on time worked. The assets of the fund are usually maintained in a separate account from the local's general funds. The fund is usually administered by the local's business manager under the general supervision of the local's board of directors.

The funds in the program are controlled exclusively by the local union. When the local union acquires knowledge of a job being bid by non-union contractors with lower wage costs, the local may notify the general contractor or the builder that a bid supplement is available to union contractors. The bid supplement is based on the total projected work hours required by the contract. Using the total hours projected, the fund manager will calculate a dollar figure targeted for that particular job. The target money will be announced for the project and will be available to any contractor who is awarded the project and who is either signed to or agrees to sign a collective bargaining agreement with the union.

If accepted, the bid supplements are paid exclusively from the funds of the "advancement" or "target" fund. They are paid periodically or at the completion of the project.

As an example of how a typical bid supplement program works, assume that a local union approves a project for 1,000 work hours. Assume also that the going wage for members of the local union is \$20 an hour and the going wage for non-union workers performing the same job is \$15 an hour. The total funding that would be made available from the target fund would be 1,000 hours at \$5 per hour or \$5,000. Assume that time sheets received by the union reflected 100 hours worked in one month by union workers. The fund office would forward \$500 to the contractor as a supplement for that month. If the contractor completes the job in 900 hours, the total supplement for that project from the union would be \$4,500. If the contractor completes the project in 1,000 hours, the total supplement for that project from the union would be \$5,000. If the contractor completes the project in more than 1,000 hours, the total supplement for that project from the union would be \$5,000, based on the 1,000 work hours originally approved.

A rebate program works in the same general way, except that the target money is made available to the customer if that customer hires a union contractor. The cash payment is usually made to the customer in the full amount at the end of the project.

The local unions state that these bid supplement and rebate programs will enable union contractors to be more competitive with non-union contractors. Thus, the encroachment from "unfair" competition by non-union employers, who pose a threat to the future well-being of the local union and its members, will be controlled through a more competitive marketplace. In addition, the unions believe that in a competitive marketplace there will be more work opportunities and greater employment stability available for the local union and its members. Moreover, the union believes that skilled craftsmen working under a collective bargaining agreement at a fair wage will provide the highest quality construction for the consumer. Finally, the target funds may be used to promote efforts to organize unrepresented groups of employees.

4. Involvement of the Department of Labor

Because the bid supplement and rebate programs might give the appearance to some of a kickback or an illegal transfer of funds, the unions decided to check with various agencies within the U.S. government, starting with the Department of

Labor. In 1986, a representative of one of the locals of the International Brotherhood of Electrical Workers formally asked the U.S. Department of Labor whether the union's practice of making cash payments to contractors who are either signed to a collective bargaining agreement with the funding local, or who agree to sign a contract with the Union, would contravene any provisions of the Labor-Management Reporting and Disclosure Act of 1959, as amended (LMRDA) or any applicable Department of Labor regulation. The relevant portion of the reply from the Director of the Office of Standards, Technical Assistance and Disclosure, U.S. Department of Labor is as follows:

"This kind of proposal has never previously been brought to our attention. However, as I understand it, the planned operation of the target program would not appear to violate any provision of the LMRDA or related regulation administered by this Office. Of course, the Local's receipt and disbursement of program funds must be included in the financial report required each year under section 201(b) of the Act.

"I cannot speak to whether the Local's planned activity would violate any other Federal law. Nor can I advise concerning whether the Local's target program would be in violation of any internal rule of the International Brotherhood of Electrical Workers. You may wish therefore, to discuss this matter with personnel at the National Labor Relations Board and the Department of Justice and with representatives of the international union."

5. Requests for Rulings from the IRS

With a copy of the 1986 Department of Labor letter as an exhibit, various local unions began asking the Service for rulings that the bid supplement and rebate programs constitute a betterment of the conditions for union members, that the programs are not construed to be inurement to union members, and that the programs will not jeopardize the union's tax exempt status under IRC 501(c)(5). Starting in 1987, IRS has routinely approved the bid supplement and rebate programs of a wide variety of local construction-related unions. A typical ruling letter is shown in Exhibit A of this article.

Building on the Labor Department's approval, the Service has found that the programs as described, in general, are directly related to the union's efforts to

improve and stabilize the wages paid in its particular industry. Therefore, the object of the bid supplement and rebate programs is to better the conditions of those working in the industry and the programs are not to be construed as inurement of earnings to the benefit of union members.

6. Conclusion

Inasmuch as the Service has consistently ruled favorably with regard to the bid supplement and rebate programs since 1987, there exists a clear decision within the Service that the purposes of these programs are within IRC 501(c)(5) purposes. Thus, in the future, absent some major deviation or change in a local union's particular program, local unions and practitioners should consider whether they need a private letter ruling, or can proceed with reasonable confidence that their program would meet with Service approval.

EXHIBIT A

Dear Applicant:

This letter is in reply to a ruling request submitted on your behalf by your authorized representative. Your request involves the effect, if any, upon your tax exempt status of your proposed bid supplement and rebate programs.

You are an organization recognized exempt under section 501(c)(5) of the Internal Revenue Code. You are organized to carry out the betterment of conditions of workers, the improvement of the grade of their products, and the development of a higher degree of efficiency in their occupations.

Your membership has approved a resolution for creation of a program to be known as the "**** ** Advancement Program" for the exclusive purpose of promoting the organized *** construction industry within the jurisdiction of Local *** by such means as bid supplements or rebates on certain jobs, advertising, educational programs, productivity studies, and related activities.

The *** ** Advancement Program will be funded by special assessments of all your members in an amount equal to *% of gross earnings. The assets of the Program shall be maintained in a separate account designated as the *** ** Advancement Program. The Program shall be administered by your Business Manager under the general supervision of your Executive Committee.

The bid supplement program will work as follows. Your Business Manager will review upcoming construction projects for which bids are being solicited. You will determine which projects are going to be included in the *** ** Advancement Program. You will, based on an estimate of the number of hours of *** work to be performed on the job, calculate a total dollar amount you will target for the job. This target money will be announced for the project and will be available to any contractor who is awarded the project, and who is either signed to or agrees to sign a collective bargaining agreement with you. The cash payment will be made at the completion of the project. There will be no employer involvement in this process.

The rebate program will work the same way, except that the target money will be available to the customer, if the customer hires a union contractor.

You state that the bid supplements and rebates will enable union contractors

to be more competitive with non-union contractors. Thus, you state that the unfair competition from non-union substandard employers, which poses a threat to the future well-being of you and your members, will be controlled. You also state that with a competitive marketplace, there will be more work opportunities and greater employment stability available for your members. You further state that the skilled *** ** craftsman, working under a collective bargaining agreement at a fair wage, will provide productive *** construction to the consumer.

Section 501(c)(5) of the Code provides for the exemption from federal income tax of labor, agricultural, or horticultural organizations.

Section 1.501(c)(5)-1(a) of the Income Tax Regulations provides that the organizations contemplated by section 501(c)(5) of the Code as entitled to exemption from income taxation are those which: (1) have no net earnings inuring to the benefit of any member, and (2) have as their objects the betterment of the conditions of those engaged in such pursuits, the improvement of the grade of their products, and the development of a higher degree of efficiency in their respective occupations.

We find that your *** ** Advancement Program as described is directly related to your efforts to improve and stabilize the wages paid in your industry. Therefore, its object is to better the conditions of those working in the industry.

Based on the information submitted and the representations made therein, we rule as follows:

1. The payment of bid supplements to union contractors, or the payment of rebates directly to the customer, from your *** ** Advancement Program within your jurisdiction constitutes a betterment of the conditions for union members and these supplements will not be construed as an inurement of earnings to the benefit of union members.

2. The proposed actions of the *** ** Advancement Program do not jeopardize the tax exempt status of *** ** under section 501(c)(5) of the Code.

These rulings are based on the understanding that there will be no material changes in the facts upon which they are based. Any such changes should be reported to your key District Director. We are informing your key District Director of this ruling. Because this letter could help resolve questions about your exempt status, you should keep it in your permanent records.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter. For other matters, including questions concerning reporting requirements, please contact your key District Director.

Sincerely yours,